THE DIRECTOR OF
CENTRAL INTELLIGENCE

National Intelligence Officers

NI #1756-77

14 July 1977

NOTE FOR: The Director

SUBJECT : Soviet Economic Prospects Paper (Unclassified Version)

This is the final version of the unclassified Soviet Economic Prospects paper, revised and screened in accordance with your instructions. It has been cleared by the DDI, the NIO/E, and the Acting NIO/USSR. It has not been seen by anyone outside the CIA.

As before, I strongly recommend that you touch base with Brzezinski and Vance so they will not be surprised by its appearance. I have attached two extra copies for transmittal to them, if you wish to do so.

Robert R. Bowie
D/DCI/NI

16 JUL 1977

Attachment

Bowie.

Bob - This & earlier versions should be classified until a determination is made - Pls go back + classify previous drafts (over)

I've modified the summary
Because it is stylistically poor
& often inaccurate in conveying the
thought. When I finished, however,
I believe that there is no
organization to it — it just
rambles along. That's why I
revised it for my oral presentation
& I don't think this follows
that (which wasn't very good
either). We're on show with this —
let's reorganize these #'s form a
meaningful outline, & to eliminate
the considerable duplication —

I'd like to print it up in
a cover that describes it as a
report prepared for JEC - ok?

Seems to me a reasonable plan
would be to say: 1) Sov 5 year plan says
labor & investment going down but productivity
up; 2) We doubt it because... ; 3) Soviets
could take actions a, b, c but these would
only mitigate; 4) Here's Sovs will face
following options: a, b, c, d —

Soviet Economic Problems and Prospects

Summary

The outlook for the Soviet economy over the next five to ten years is bleak. Reliance on rapid increases in labor and capital -- the main formula for growth used over the last 25 years -- will no longer be feasible. Growth of the labor force will be sharply reduced in the 1980s, and there is little reason to expect productivity trends to improve. Moreover, a new problem -- the prospect of a substantial decline in oil output in the early to mid-1980s may further constrain the economy.

In dealing with these problems, Moscow has various options, all of which have substantial costs, none of them attractive, including:

-- Severely reducing exports of oil to Eastern Europe;

-- Seeking new sources of help from the West, such as long term joint ventures for energy development financed by long-term credits [under government guarantees;]

-- Cutting military programs and manpower;

-- Introducing far reaching economic reforms;

-- Or simply, tightening its belt.

necessary unlikely to be private, but could be

All of these policies would involve difficult domestic or foreign policy trade offs for Moscow and none of them are likely to do more than alleviate the economy's basic problems.

Basic Problems - Labor and Productivity Growth

The impact of the decline in birth rates in the 1960s, already reflected in a decline in the number of new entrants into the labor force, will become much more acute in the early to mid-1980s. The reservoir of redundant farm labor has already been siphoned off to develop other

sectors. Moreover, additions to the labor force will come mainly from ethnic minorities in Central Asia who do not readily move to labor-short northern industrial areas.

Productivity gains from ~~of both~~ labor and from investments in plant and equipment have been slowing for years, and there are new problems likely to depress productivity.

° The growth of investment outlays is slowing down and is programmed by the latest Five Year Plan to continue at low rates at least to 1980. This will

give less opportunity for replacing obsolescent ~~with new~~ plant and equipment. with new,

- Fuels and other industrial raw materials will become more expensive, largely because of the depletion of reserves west of the Urals and the costly effort to develop resources in Siberia and Central Asia.

- The costs of producing technologically sophisticated products are rapidly rising.

? unclear

- A looming oil shortage may create bottlenecks and will almost certainly force curtailment of critical imports of capital goods from the West.

The Energy Problem

The Soviets are not finding and developing new oil deposits rapidly enough to offset declines in older fields. As a result, production will begin to fall in the late 1970s or early 1980s. Last year's oil production of 10.4 million barrels per day was close to the estimated maximum potential of 11 million to 12 million b/d. By 1985 oil output is expected to fall to between 8 million and 10 million b/d. In addition to the failure to find new deposits to offset depletion, production techniques now in use—such as excessive water flooding—focus on short-term gains at the expense of maximum lifetime recovery.

~~Without them, oil production will fall sooner rather than later~~. Beyond the mid-1980s, the USSR is counting on large new supplies of oil and development of alternative energy sources—coal, natural gas, and hydroelectric power. Most potential major sources lie east of the Urals, far from major industrial and population centers: their development would take years and require massive capital investment.

Even if the development of other energy sources is pushed to the maximum, the rate of growth of energy output will fall—a plausible scenario projects a decline from 4 percent in 1976-80 to slightly above 1 percent in 1981-85. Soviet energy consumption has closely paralleled the growth of the economy. As a result, the sharp slowdown in energy production threatens to impede economic growth in a major way unless Moscow saves massive

I don't know how this would [illegible] from [illegible] regarding economic growth

amounts of energy and/or [allows a major turnaround from its present net energy export position to a net import position.]

Energy savings are difficult to come by; large sources of oil saving are more difficult to identify in the USSR than in the West because a large share is for commercial and industrial use. As a result, opportunities for oil conservation that would not hinder production are more limited than in the West. The more the Soviet government delays adoption of a top-priority energy program, the greater the economic impact in the 1980s.

Impact on Hard-Currency Imports

The oil problem could have a severe impact on the USSR's ability to import from the West.

- Last year oil accounted for more than one-half of the USSR's hard-currency earnings.
- Continuation of present policies could lead to a shift from selling 1.2 million b/d of oil in 1976 to pressure for buying large amounts—according to a plausible scenario ~~imports~~ requirements would be 2.7 million b/d in 1985—a net shift of about US $16 billion.
- Under these circumstances if Moscow did not cut oil exports to Eastern Europe, it would have no hard currency left to buy any manufactured goods from the West.

Such an outcome would be difficult for Moscow to accept, but it cannot escape some difficult and painful choices. Even with ~~an~~ all-out Soviet effort, average annual growth of nonoil hard-currency exports probably could not exceed 10 percent in real terms; and these added earnings, together with those from gold sales and arms, would offset only part of the hard-currency loss due to the oil shift. Credits will contribute little to import capacity because of growing debt service. Moscow~~'s~~ has ~~opportunities~~ few acceptable exports to barter for oil from Middle Eastern countries rather than pay hard currency ~~for it appear to be limited~~ except for arms [in some cases.] ? Middle East oil producers simply have no incentive to buy Soviet goods when they have ample funds to obtain better quality Western goods.

Eastern Europe may be hit hard by Soviet decisions on oil. Eastern Europe now gets 1.3 million b/d of Soviet oil and by 1980 is scheduled to get 1.6 million b/d, a diversion of about $7 billion in potential Soviet

iii

additional potential

sales?

For .3 m/b/d! ambiguous — you must mean 1.6 b/b/d but it's not clear.

hard-currency earnings. Moscow will carefully weigh the trade-offs between continued economic support to Eastern Europe and its own exports for hard currency. There will be strong pressure to force Eastern Europe to share the burden of the oil shortage in the 1980s. Any substantial cut in oil supplies to Eastern Europe would worsen its already difficult economic situation.

Agriculture—A Continuing Problem

Agriculture will remain a major economic headache. Soviet farm production still cannot provide the quality diet that the Soviet population desires; demand for meat is rising faster than incomes. Much of the past rise in farm output reflects a massive infusion of investment, but the weather has been responsible for roughly half of the increase in grain production between the early 1960s and 1974. Despite these favorable conditions, imports of farm products have accelerated in recent years.

If the climate in the principal grain areas does return to the harsher—but, we believe, more normal—conditions of the early 1960s, we expect grain imports, and the resulting burden on scarce hard-currency supplies, will be substantial.

Outlook for Economic Growth

A marked reduction in the rate of economic growth in the 1980s seems inevitable. A plausible forecast is for a rate of growth of GNP averaging about 4 percent a year through 1980, and roughly 3 percent in 1981-85. This projection is based on (a) expected trends in inputs of labor and capital; (b) continuation of productivity trends of the past decade or so; (c) the midpoint of a likely range of energy output, and (d) energy conservation on a priority basis.

Economic growth could be substantially slower than this. If the output of energy falls to the lower end of the expected range, or there is little conservation, growth in GNP could be limited to an average of 2 percent a year. ~~by an energy shortage.~~ (repetitive)

The possibility of achieving substantially higher growth seems small. Moscow's policy options on the manpower problem are limited. Several measures could be adopted, but will have a limited and temporary effect on labor force growth.

- Older workers could be retained longer in the labor force.

- More young workers could be brought into the labor force by changing education policies.

- The armed forces could be reduced by shortening the term of service.

Moscow's options for affecting the productivity of investment are even more constrained.

- The Soviets could shift industrial capacity from defense to the production of investment goods. Defense production is what the Soviets do best and they would be reluctant to undermine that capability. Moreover, specialized defense resources are not easily transferred on short notice.

- Moscow could stretch out research and development and production schedules and slow the rate of expansion of defense-oriented industrial capacity, but this would have little effect~~, at least~~ in the short run.

- The Soviets could try to improve productivity through reforms of economic management. With the powerful bureaucratic vested interests, however, there is virtually no chance for reforms far-reaching enough to spur the economy through the mid-1980s.

Even a combination of these measures—such as a leveling off of defense production, coupled with measures to obtain additional manpower—would probably raise economic growth only slightly. Moreover, high growth would increase the demand for oil and thus make the potential shortage greater.

These are *average* figures; performance in some years could be better, but also worse, with zero growth or even absolute declines in GNP a real possibility if oil shortages and a bad crop year coincide.

Impact on Defense

The slowdown in economic growth is likely to trigger intense debate in Moscow over the future levels and pattern of military expenditures. Military programs have great momentum and powerful political and bureaucratic support. We expect spending to continue to increase in the next few years at something like recent annual rates of 4 to 5 percent because of programs in train. As the economy slows, however, ways to reduce the growth of defense

expenditures should become increasingly attractive to major elements of the Soviet leadership.

Impact on the Consumer

The reduced growth potential means that the Soviet consumer will fare poorly during the next five to 10 years relative to recent gains. Under the growth rates posited, per capita consumption could grow no more than 2 percent a year in contrast to about 4 percent since 1965. As a result, there will be no progress in closing the gap in living standards with the West or, for that matter, with most of Eastern Europe. Moreover, the inevitable rise in wages over the next ten years combined with a slower growth in the availability of consumer goods will result in inflationary pressures and increasing frustration on the part of the consumer.

Relations with the US

Moscow's economic problems in the 1980s will strongly affect its relations with the West, especially the United States. Even under favorable assumptions for hard-currency earnings, Soviet ability to import from the West in the early and mid-1980s will almost certainly decline, probably substantially. Moscow, therefore, may ~~ask for~~ need long-term credits (10 to 15 years), especially to develop oil and gas resources. The USSR ~~needs~~ requires US technology to do this rapidly. ~~Long-term credits would require government guarantees.~~

Choices for the Leadership

As Soviet leaders obtain a better perception of the resource problems ahead, they will be led to consider policies rejected in the past as too contentious or lacking in urgency. Some leaders might be persuaded that basic organization and management reforms in industry are necessary. But that will raise the spectre that such reform would threaten political control. Consideration of other options—such as accelerating investment at the expense of defense or consumption, or reducing the armed forces to enhance the civilian labor force—could also result in strong leadership disagreements.

Soviet responses to economic problems could be complicated by the fact that leadership changes will almost surely take place during the coming period.

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The Director
Central Intelligence Agency

Washington, D.C. 20505

18 JUL 1977

Dear Zbig,

Attached is a memorandum that attempts to put in perspective some of the questions raised in the course of Brezhnev's recent visit to Paris and to assess his overall position.

Yours,

/s/ Stansfield Turner
STANSFIELD TURNER

Att: a/s

The Honorable Zbigniew Brzezinski
Assistant to the President for
National Security Affairs
The White House
Washington, D.C. 20506

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Remarks:

Attached is a memorandum that attempts to put in perspective some of the questions raised in the course of Brezhnev's recent visit to Paris and to assess his overall position. Dr. Brzezinski might be interested, since he presumably saw the original reports that raised the puzzling questions.

Sayre Stevens
DDI

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Cover Memo to SC - [illegible]

The Direc[tor]
Central Intelligence Agency

Washington, D.C. 20505

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